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8 Attorneys For Creditor Conntechical Industries, Inc.

9 **UNITED STATES BANKRUPTCY COURT**
10 **NORTHERN DISTRICT OF CALIFORNIA**

11 **In re:**

12 **CT DRIVES, LLC,**

13 Debtor.

Case No. 11-60198 SLJ 11

Chapter 11

14 **CREDITOR CONNTECHNICAL**
15 **INDUSTRIES, INC.'S OBJECTION**
16 **TO CONFIRMATION OF DEBTOR'S**
17 **PROPOSED THIRD AMENDED**
18 **PLAN OF REORGANIZATION**

19 Date: September 6, 2012

Time: 1:30 p.m.

Place: United States Bankruptcy Court
280 S. First St., Room 3099
San Jose, California 95113

Judge: Hon. Stephen L. Johnson

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23 Creditor Conntechical Industries, Inc. ("Conntechical") hereby objects to confirmation of
24 the proposed Third Amended Plan of Reorganization (the "Plan") of debtor CT Drives, LLC
25 ("Debtor").
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I. INTRODUCTION

Debtor has no real business operations, and has lost money throughout its nine months in Chapter 11. As Conntechnical will explain, the Plan is a very thinly disguised attempt to maintain the status quo – by letting Debtor’s insider equity holders keep their interests – while repaying nothing (or next to nothing) to Debtor’s only sizable creditor, Conntechnical. The Plan wholly fails to meet the requirements of Bankruptcy Code Sections 1129(a)(3), 1129(a)(7)(A), 1129(a)(8), 1129(a)(10) and 1129(a)(11), and therefore cannot be confirmed. Further, even if those failures could somehow be ignored or excused (which they cannot), Debtor still cannot “cram down” the Plan, because Debtor cannot meet the requirements of Section 1129(b)(1) or (b)(2)(B): The proposed Plan is not fair and equitable [§ 1129(b)(1)]; it does not provide that unsecured creditors will receive anything close to the value of their claims [§ 1129(b)(2)(B)(i)]; and it impermissibly calls for existing equity holders (who, not surprisingly, claim to support the Plan) to retain their interests [Section 1129(b)(2)(B)(ii)].¹

In addition, Debtor’s transparent attempt to create a favorable impaired class (Class 3a) by segregating Conntechnical (and a related entity) from the other unsecured creditors is impermissible, particularly since (a) the Plan proposes to treat all unsecured creditors identically, and (b) the only two voting creditors in Class 3a are two of Debtors’ lawyers, who are also equity holders and who may not even be unsecured creditors.

Finally, Debtor’s most recent Operating Report (for July 2012) shows zero sales, zero expenses, zero bills paid and, in short, no business activity. The outdated and unsubstantiated projections attached to Debtor’s Third Amended Disclosure Statement (the “Disclosure Statement”) are proved false by actual operating reports. A so-called “reorganization” under which existing equity holders keep their equity (at that, diluted by shares issued to management post-confirmation) and the unsecured creditors receive virtually nothing is not a reorganization. It is a scheme to permit Debtor’s massive transfers to insiders to go uninvestigated and unredressed, and to let the current owners keep their equity, while the ostensible lack of money in the company is used as an excuse to

¹References herein to section numbers are to the United States Bankruptcy Code (U.S.C. Title 11).

1 escape paying anything to creditors.

2 As Conntechnical will explain in more detail below, each and all of these shortcomings
3 prevents the Plan from being confirmed.

4 5 **II. FACTUAL BACKGROUND**

6 Debtor's Plan provides, *inter alia*, as follows:

7 Class 1a consists of the allegedly secured creditors listed on Debtor's Schedule D; and Class
8 4 consists of the equity holders listed on Debtor's List of Equity Security Holders filed November 4,
9 2011. The Plan characterizes the Class 1a claimants as secured note holders, and provides for them
10 to receive equity unit ownerships in the reorganized company proportionate to their current
11 percentage of the secured debt outlined on Schedule D. However, both the Plan and Disclosure
12 Statement fail to disclose that every single "creditor" listed on Schedule D *is also an existing equity*
13 *holder as identified on the List of Equity Security Holders. I.e., every Class 1a creditor is also a*
14 *creditor in Class 4 (equity holders).*

15 The Plan states that all Class 4 equity interests will be canceled, but this is illusory: All the
16 Class 1a creditors, who comprise the majority of the Class 4 equity holders, will keep their equity. It
17 appears that the purpose of this artifice is to permit the Class 1a creditors to retain their equity
18 interests at the expense of the unsecured creditors to whom the Class 1a creditors otherwise would
19 have to be constructively subordinated [§ 1129(b)(2)(B)(ii)].

20 Classes 3a and 3b *each* consist of general unsecured creditors. While Debtor attempts to
21 justify having two classes of unsecured creditors on the ground that Class 3a consists of trade
22 creditors and Class 3b consists of note and litigation creditors, both Class 3a and Class 3b are to
23 receive *exactly the same treatment*. Debtor proposes to pay the creditors in both Class 3a and 3b a
24 total of 8 percent of their allowed claims, over a 24-month period. Conntechnical, which is the sole
25 creditor in Class 3b [together with its principal, Connard Cali ("Cali") and related entity Positork
26 Distributing, Inc. ("Positork")], is owed at least \$590,027.06. Class 3a consists of trade creditors –
27 apparently only two in number – who are attorneys for Debtor and are alleged to be owed only

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1 \$14,206.11.² Thus, Conntechnical holds at least 98 percent of the unsecured debt in this case.
2 Conntechnical has been segregated in a separate unsecured creditor class (Class 3b) in order to
3 contrive a small class (Class 3a) that would vote to accept the Plan.

4 Debtor's counsel filed its Ballot Summary and Tabulation on August 20, 2012. The Class 1a
5 and 1c (a single small administrative claimant) ballots were voted in favor of accepting the Plan.
6 The two attorneys who comprise the Class 3a creditors (with claims aggregating \$14,206.11) voted
7 to accept the Plan; the Class 3b creditors (including Conntechnical's claim of at least \$590,027.06)
8 voted to reject the Plan. About 92 percent of the Class 4 creditors (most of whom are also Class 1a
9 creditors) voted to accept it. As Conntechnical will explain, a sizable number of the Class 1a ballots
10 were cast by apparent insiders holding one-half to two-thirds of the dollar amount of Class 1a
11 claims; thus, Class 1a has not accepted the Plan pursuant to Section 1126(c). The single
12 administrative claimant comprising Class 1c is not entitled to vote. [§ 1126(a); see *In re Boston Post*
13 *Road Ltd. Partnership*, 21 F.3d 477, 484 (2d Cir. 1994).] Class 4 cannot be deemed to have
14 accepted the Plan because its members are not receiving or retaining any property [§ 1126(g)].
15 Thus, no impaired class has accepted the Plan except the "gerrymandered" Class 3a. Under such
16 circumstances, there is no basis for confirming the Plan under either Section 1129(a) or 1129(b).

17 18 III. LEGAL ANALYSIS

19 The Court may confirm a plan only if all the requirements of Section 1129(a) are met. An
20 exception to this rule is found in Section 1129(b)(1), which states that if all of the requirements of
21 Section 1129(a) are met except Section 1129(a)(8) (which provides that each class must either have
22 accepted the plan or be unimpaired thereunder), the Court may confirm a plan if it "does not
23 discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is
24 impaired under, and has not accepted, the plan." Further, Section 1129(b)(2)(B)(ii) states that a plan
25 is only "fair and equitable" to an unsecured creditor if *either* he receives or retains property equal to
26 the allowed amount of his claim *or* no creditor junior to him receives anything under the plan.

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28 ² The likelihood that these two attorneys have been improperly used to artificially create a tiny
impaired class is discussed in more detail in Part III(A), *infra*.

1 As Conntechical will explain, the Plan in this case broadly fails to meet these requirements.
2 First, numerous prerequisites to confirmation under Section 1129(a) are not met. Second, the Plan
3 cannot be confirmed under Section 1129(b)(1) because it discriminates unfairly against unsecured
4 creditors, and is not fair and equitable in that, among other things, it permits insiders to retain both
5 transferred assets and equity interests while unsecured creditors receive virtually nothing.

6 **A. The Plan Has Not Been Accepted by Creditors.**

7 A class has accepted a plan if holders of at least two-thirds in dollar amount of the interests
8 held by class members have voted in favor of it. [§ 1126(d).] Debtor has not obtained sufficient
9 votes.

10 *First:* Class 1a has not accepted the Plan, because it appears that non-insider votes represent
11 no more than half , and evidently only about one-third, of the dollar amounts claimed by class
12 members – far short of the two-thirds required under Section 1126(c). Debtor has not made it
13 possible to calculate the relevant numbers with complete precision, because ballots were cast by
14 Joyce Higashi and Patrick Higashi, presumptive insiders who are *not* listed as creditors on Debtor's
15 Schedule D. However, insider creditors who are listed on Schedule D and whose ballots were
16 counted by Debtor include: Wayne Higashi [§ 101(31)(B); listed on Schedule D at \$10,150.00],
17 Steven Higashi [§ 101(31)(B)(vi), \$3,686.50], Douglas and Tomoko Higashi [§ 101(31)(B)(vi),
18 \$10,150.00], the Higashi Family Trust [§ 101(31)(B)(vi), \$15,300.00], Higashi's company ITLMC
19 [§ 101(31)(E), \$27,349.06] and Robert Marangell [§ 101(B)(iii), \$10,150] – totaling \$76,785.56 out
20 of \$155,553.79 in total Class 1a claims. Thus, non-insiders representing no more than 51 percent of
21 the total dollar amount of Class 1a claims have voted for the Plan. Furthermore, the ballots signed
22 by Joyce Higashi and Patrick Higashi almost certainly relate to claims of other Higashi family
23 members. With these latter claims included in the tabulation, insider claims would total at least 56
24 percent of the dollar amount of Class 1a ballots cast, and non-insider claims no more than 44
25 percent.

26 Moreover, Debtor's Ballot Summary and Tabulation appears to represent that the total
27 amount of Class 1a claims is \$134,135.00, rather than the \$155,553.79 total set forth in Debtor's
28 Schedule D. Based on the \$134,135.00 figure, non-insider votes represent only 35 to 43 percent of

1 the total claims.

2 A class has accepted a plan if it has been accepted by claimants who hold at least two-thirds
3 of the dollar amount of the class's allowed claims. [§ 1126(c).] In determining whether an impaired
4 class has accepted a plan, insider votes are not counted. [§ 1129(a)(10).] In short, with regard to
5 Class 1a, Debtor has fallen far short of the requirements of Section 1126(c).

6 *Second:* Class 1c has not accepted the Plan, because its sole creditor is a small post-petition
7 administrative claimant, not entitled to vote.

8 *Third:* Classes 3a and 3b are improperly “gerrymandered” for the transparent purpose of
9 creating a tiny impaired class (Class 3a, consisting of two voting creditors, with claims aggregating
10 \$14,206.11). As explained more fully in Part E, *infra*, those two creditors and the Conntechnical
11 creditors (Class 3b) are treated exactly the same under the proposed Plan; thus, Conntechnical's vote
12 to reject the Plan represents 98 percent of the amount of claims of general unsecured creditors.
13 Further, these two voting creditors (Barry Young and Thomas Bahrck) are each attorneys for the
14 Debtor, and are also Class 1a creditors by virtue of having received equity in exchange for legal
15 services. Especially since Debtor apparently paid virtually all of its unsecured claims (except
16 Conntechnical's) pre-petition, it is reasonable to conclude that either Messrs. Young and Bahrck
17 were not actually owed the small amount of cash Debtor claims they are owed, or Debtor forbore
18 from paying them the \$14,206.11 pre-petition in order to artificially populate a tiny impaired class
19 (Class 3a) that would enable debtor to argue that Section 1129(a)(10) was satisfied.

20 *Fourth:* Class 4 must be deemed not to have accepted the Plan, because the Plan states that
21 the members of Class 4 will not receive or retain any property under the Plan. [§ 1126(g).]

22 Because no impaired class has accepted the Plan, Debtor has failed to meet the requirements
23 of Section 1129(a)(10), and the Plan cannot be confirmed under Section 1129(b)(1). Accordingly,
24 the Court need not even consider Debtor's failure, as explained below, to comply with numerous
25 other subsections of Section 1129(a).

26 **B. The Plan Is Not Proposed in Good Faith [§ 1129(a)(3)].**

27 Even if the Court were to determine, on some basis, that the requirements of Section
28 1129(a)(10) had been satisfied, Debtor's failure to meet the requirements of numerous other

1 subsections of Section 1129(a) would preclude confirmation. One such requirement, found in
2 Section 1129(a)(3), requires that in order to be confirmed, a plan must be proposed in good faith.

3 The evidence of Debtor's bad faith, both prior to and during this Chapter 11 case, is set forth
4 at length in Conntechnical's motion to convert the case to Chapter 7, scheduled for hearing on the
5 same date as the confirmation hearing. Conntechnical will not repeat here all of the arguments made
6 in connection with the motion to convert, but will briefly recapitulate the facts showing bad faith:

- 7 • Debtor has made massive transfers – exceeding its historical gross sales – to manager
8 Wayne K. Higashi (“Higashi”), insiders, and other Higashi companies.
- 9 • Debtor has no “hard copy” books, records, bank statements, cancelled checks or any
10 other financial documents. It only has a computerized “QuickBooks” file, with
11 no “backup” or any means for confirming the accuracy or completeness of anything
12 contained therein.
- 13 • In fact, Higashi conscientiously altered thousands of entries in the QuickBooks file just
14 before producing them in discovery, for the purpose of attempting to conceal improper
15 expenditures and transfers.
- 16 • Debtor gave security interests to the so-called secured note creditors (Class 1a) within
17 one year prior to the petition date. Every one of these creditors was already an equity
18 holder in Debtor, and they are either insiders [as defined in Section 101(31)(B)] or
19 friends of Higashi. The Plan proposes to pay them nothing, but to let them retain their
20 equity positions; yet they have been erroneously classified as being senior to the general
21 unsecured creditors. Further, because they were already equity holders at the time they
22 supposedly made the loans that were to be secured by company assets, any such infusions
23 of cash were actually contributions to capital, incapable of creating a security interest in
24 addition to an equity interest.
- 25 • Debtor has unjustifiably paid debts of other Higashi companies, and attempted to conceal
26 such payments.
- 27 • Debtor has withheld federal taxes from wages paid, but failed to remit the withheld funds
28 to the Internal Revenue Service.

- 1 • Debtor has existed in Chapter 11 by borrowing money, but has neither sought nor
2 obtained Court approval of any such borrowing.
- 3 • Debtor offered to sell Cali \$60,000 worth of Facet-branded pulleys which Higashi
4 represented Debtor had in its possession. However, Debtor does not report having any of
5 this inventory, or its sale. It can only be assumed that Higashi has removed it, or sold it
6 outside Debtor's business.
- 7 • Debtor has serious patent infringement problems, has no apparent inventory, and has
8 suffered other setbacks that have caused Higashi to consider dissolution.
- 9 • Debtor bases its predictions of future profitability on a *September 2011* balance sheet and
10 the wholly unsupported opinion of Higashi. However, Debtor's operating reports show
11 only losses throughout the pendency of this case. Indeed, the report for July 2012, filed
12 just three days ago, reveals a company that does not exist as a going business: It reports
13 no sales or other income, no outlays (except a single \$10 bank charge), no checks written,
14 and no expenses. It wrote no checks in July. The company's liabilities are 2½ times its
15 assets. And in prior months when it has reported sales, the cost of goods sold has
16 exceeded the gross revenue from the sales. This is hardly an enterprise poised to emerge
17 from Chapter 11 in two weeks and earn a profit for its creditors.
- 18 • Debtor's July Operating Report raises many other serious questions:
 - 19 ○ The Balance Sheet attached to the report shows receivables of \$39,358.45, but
20 under "Money Owed to You", Debtor reports receivables of only \$32,000.
 - 21 ○ Those receivables which do exist arise from orders that Debtor cannot fill because
22 of its lack of cash.
 - 23 ○ Debtor's credit card balance has increased since the June Operating Report, but
24 the July statement shows no expenses that could be tied to credit card charges.
 - 25 ○ Despite its failure to remit withholding taxes to the IRS, Debtor claims to be
26 current on all tax obligations.
 - 27 ○ Debtor reports having more than \$16,000 on hand, but paid no bills in July, even
28 its credit card liability of \$314.66.

- Debtor's unrelenting losses and lack of business activity demonstrate that there is no conceivable basis for the projections of \$50,000 a month in license revenue, plus other income, following confirmation. Debtor admits that the projections came off the top of Higashi's head; they are illusory.
- Debtor's Plan proposes to let the so-called note holders keep their equity interests (albeit diluted by issuance of additional shares to management), and to pay 8 cents on the dollar to unsecured creditors. Debtor's projections, and performance, show no ability even to pay that paltry sum; on the other hand, if Debtor's projections had any validity, there would be no excuse for not paying substantially more than that amount.

In short, confirmation of the Plan would simply maintain the status quo – a “shell” company looted by its management and owned by insiders and friends – except that its only real creditor (Conntechnical) would be shed for virtually nothing.

This is not a company that has a body of creditors, and wants to reorganize in order to pay them. It is the antithesis of such a company, and thus a classic example of bad faith. For that reason alone, Section 1129(a)(3) has not been satisfied, and confirmation must be denied.

C. Unsecured Creditors Will Not Receive Property Equivalent to What They Would Receive in the Event of a Liquidation [§ 1129(a)(7)(A)].

Section 1129(a)(7)(A) requires that *every* creditor in an impaired class that has not accepted the Plan receive or retain at least as much as if the Debtor were liquidated under Chapter 7.

As Conntechnical has explained, Debtor has failed to attribute any dollar value to its assets, which include its 45 percent interest in ES Design and substantial intellectual property. (As set forth in Conntechnical's Memorandum in support of its motion to convert, Debtor thought enough of ES Design to pay its expenses, and then cover up those payments by altering its books and records.) In addition, Debtor has given zero value to what appear to be strong cases for recovery of avoidable transfers made to insiders and other related entities. Debtor does not even come close to meeting the requirements of Section 1129(a)(7)(A).

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1 **D. All Impaired Classes Have Not Accepted the Plan [§ 1129(a)(8)].**

2 As explained hereinabove, no impaired class has accepted the Plan. Section 1129(a)(8)
3 requires that *each* such class have accepted the Plan.

4 **E. No Impaired Class Has Accepted the Plan; and an Artificial Accepting Class Cannot**
5 **Be Created through Improper Segregation of Claims [§ 1129(a)(10)].**

6 Also as explained hereinabove, there is no impaired class that has accepted the Plan.
7 Accordingly, the requirements of Section 1129(a)(10) have not been met.

8 Debtor attempts to create an accepting class, Class 3a, consisting of two of Debtor's
9 attorneys, who are also equity holders, and whose putative claims total just \$14,206.11; and to
10 arbitrarily place Conntechnical (with a claim of at least \$590,027.06), together with related entity
11 Positork (which has not filed a proof of claim seeking any specific payment amount), in a separate
12 Class 3b. The ostensible justification for this bifurcation is that the Class 3a creditors are trade
13 creditors, and the Class 3b creditors are note or litigation creditors. Debtor has not objected to any
14 claims, and assumes their validity for purposes of Plan balloting.

15 The obvious purpose of such separate classification is "gerrymandering an accepting
16 impaired class in violation of § 1129(a)(10)." *In re Tucson Self-Storage, Inc.*, 166 B.R. 892, 897 (9th
17 Cir. B.A.P. 1994). Debtor's assertion that it may object to one or more unsecured claims in the
18 future cannot disguise the plain fact that, under the Plan, all allowed unsecured claims are treated
19 identically. That unsecured claims arose from different kinds of transactions does not permit
20 "gerrymandering" them into separate classes. Moreover, as explained hereinabove, the two lawyers
21 who represent the only Class 3a votes received equity for services, and appear to be the only "trade
22 creditors" not paid pre-petition; these two small claims were manufactured and segregated solely to
23 create a minuscule impaired class whose two members would vote to accept a plan.

24 Where, as here, a debtor's proffered "reasons" for separately classifying claims "simply mask
25 the intent to gerrymander the voting process", such a classification scheme must be disapproved.
26 *Matter of Greystone III Joint Venture*, 995 F.2d 1274, 1279-81 (5th Cir. 1991); *In re Tucson Self-*
27 *Storage, Inc., supra*, 166 B.R. at 897.

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F. It Is Likely that Confirmation Would Be Followed by Liquidation and/or Further Reorganization [§ 1129(a)(11)].

As explained more fully in Conntechical's motion to convert this case to one under Chapter 7, Debtor has no prospects for profitability. It has experienced nothing but losses from the very beginning, when Higashi drained it of most of its initial operating capital; it has paid out more in insider management fees than its total historical gross sales; it has lost more than \$1,733,000 in just four years of business; and despite the automatic stay and other protections under Chapter 11, it has lost money every month since the petition was filed.

Unless this company is, in gross bad faith, *designed and intended* to lose money, it is likely that confirmation would be followed by liquidation or the need for further financial reorganization. Accordingly, the requirements of Section 1129(a)(11) are not met, and the Plan cannot be confirmed.

G. Even If the Requirements of Section 1129(a) Somehow Were Deemed To Have Been Met, the Plan Could Not Be Confirmed Under Section 1129(b).

Because the Plan does not meet the requirements for confirmation under Sections 1126(c) and (g), or Sections 1129(a)(3), (7), (10) or (11), the Court cannot confirm it under Section 1129(b).

If all the provisions of Section 1129(a) except 1129(a)(8) had been satisfied, the Court could confirm the Plan if it did not discriminate unfairly, and were fair and equitable, as to *each class of impaired claims* that did not accept the Plan. But even if Section 1129(b) were applicable, Debtor still has not satisfied the requirements of that subsection.

1. The Plan Discriminates Unfairly [§ 1129(b)(1)].

Debtor improperly classifies equity holders as so-called secured note creditors under Class 1a, so that they can "leapfrog" the unsecured creditors by retaining their equity interests while the unsecured creditors receive little or nothing under the Plan. Moreover, because the Class 1a creditors include Higashi, his family trust, ILMC, and other insiders who have received huge transfers of money from Debtor, the Plan effectively exonerates the insiders from any responsibility for return of avoidable transfers.

In addition, when Debtor induced Conntechical to make an unsecured loan of more than \$350,000, Debtor promised in writing that any future note beneficiary would be given "similar"

1 terms. [Declaration of Connard P. Cali, filed herewith, at ¶ 3 and Exhibit 1.] However, Debtor
2 proceeded thereafter to purportedly give the Class 1a note holders a blanket security interest all in
3 the company's assets, attempting to relegate Conntechnical to unsecured status.

4 In sum, the Plan is an exercise in unfair discrimination, letting insiders keep their equity
5 interests and all the money they have taken from the Debtor, purporting to relegate Conntechnical
6 (Debtor's only actual significant creditor) to junior status, and thereupon relieving itself of its
7 indebtedness to Conntechnical.

8 ***2. The Plan Is Not Fair and Reasonable [§ 1129(b)(1)].***

9 The proposed Plan is manifestly unfair and unreasonable, for the reasons already set forth
10 above. Management has looted the company, taking or transferring massive amounts of money to
11 themselves or related entities while doctoring the books to conceal the transfers. There are no
12 prospects for viability. Debtor granted purported security interests that either do not reflect actual
13 transactions or represent capital infusions by equity holders rather than loans – all for the purpose of
14 unfairly avoiding payment to Conntechnical.

15 Furthermore, in order to be “fair and reasonable”, a plan must provide *either* that each
16 unsecured claimant receive or retain property equal to the amount of his claim [§ 1129(b)(2)(B)(i)]
17 *or* that no claimant junior to such claimant receive any property [§ 1129(b)(2)(B)(ii)]. Here,
18 Conntechnical obviously is not receiving property equal to the amount of its claim; and the Class 4
19 equity holders who supposedly are surrendering their interests are in fact, for the most part, the same
20 persons and entities that comprise Class 1a *and are retaining their interests*. Thus, the Plan
21 flagrantly violates Section 1129(b)(2)(B).

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IV. CONCLUSION

It is difficult to imagine a plan that more transparently, and contemptuously, conceals a debtor's true intentions, or that so plainly fails to meet the requirements for confirmation under Sections 1126 and 1129. For all the reasons set forth herein, Conntechnical respectfully submits that confirmation of the Plan must be denied.

DATED: August 23, 2012

Respectfully submitted,

Peter C. Bronson
LAW OFFICES OF PETER C. BRONSON
A Professional Corporation

By: 

Peter C. Bronson
Attorneys for Creditor
Conntechnical Industries, Inc.